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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR ROLLIN G. THORLEY
ACTING ASSOCIATE COUNSEL (SMALL BUSINESS/SELF EMPLOYED)
CC:SB:5

FROM: William P. O'Shea
Acting Associate Chief Counsel
CC:PSI:FO

SUBJECT: Proper Treatment of Trust Income

This Chief Counsel Advice responds to your memorandum dated March 22, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Trusts =

X =

Y =

Date 1 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

$A =

ISSUES

(1) Are the Trusts in question properly classified as simple trusts or complex trusts for federal income tax purposes?

(2) Does state law govern the definition of “income” for purposes of the Trusts’ distribution requirements?

(3) Is checking the box on the Form 1041 to indicate a simple or complex trust binding, or can it be changed on a later return?

CONCLUSIONS

(1) Pursuant to section 1.651(a)-1 of the Income Tax Regulations, the determination of whether a trust is classified as either simple or complex is based on both the governing documents of the trust as well as the distributions actually made in a given taxable year. In this case, the Trusts are required to distribute current income periodically by the governing documents. In addition, there is no provision for the retention or accumulation of income of the trust. Finally, in all years in question, there has not been a distribution of the principal of the Trusts. Thus, the Trusts are properly classified as simple trusts for federal income tax purposes.

(2) In accordance with the regulatory scheme in place for simple trusts, state law is determinative of what items constitute “income” for a trust’s reporting requirements under § 651, as well as for any distribution obligations.

(3) The box on the Form 1041 to indicate a simple or complex trust is not determinative of a trust’s status. It can be changed on an amended return of the box was originally checked incorrectly.

FACTS

In Date 1, X Trusts, hereafter referred to as “Trusts”, were created. The Trusts were created by the Trustor executing a Declaration of Trust (“Declaration”) for the benefit of each Beneficiary and transferring to the Trustee a certain amount of cash. The Trustor of the Trusts is the same individual and is related to the Trustee and to two of the Beneficiaries under the terms of section 672(c) of the Internal Revenue Code. Furthermore, each of the Trusts has a single beneficiary all of whom are United States citizens. Some of the Beneficiaries are minors.

The Trusts' corpus involves interests in Y. In addition, at various other times, the parents of some of the Beneficiaries transferred cash to some of the Trusts.

Pursuant to the terms of the Declaration, the Trusts are irrevocable and unamendable. The Declaration specifies that the net income of Trusts is to be distributed to each Beneficiary in convenient installments. In addition, the specific named Beneficiary of each of the Trusts is the only income beneficiary. As such, the income interest will terminate upon either the death of the named beneficiary or on termination of the Trusts. Furthermore, the Declaration states that the determination between principal and income is to be governed by the provisions relating to principal and income under the laws of the state in which principal administration of the Trusts are located.

For purposes of federal income taxes, Trusts represent that they have erroneously reported and paid tax on certain income for several years. The tax years involved are: Year 1, Year 2, Year 3, Year 4, and Year 5. Trusts contend that they are all properly classified as simple trusts for federal tax purposes, pursuant to the various trust documents. However, for Year 1, Year 2, Year 3, and Year 4, Trusts made no distributions of income and both reported and paid income as if it were a complex trust. In Year 5, Trusts treated themselves as simple trusts, reporting the income to the Beneficiaries. However, Trusts now assert that the accounting income was erroneously overstated. Trusts, through their representatives, contend that the cumulative result of these errors is an overpayment on the part of Trusts of approximately $A.

LAW AND ANALYSIS

Issue One

The importance of categorizing a trust as either simple or complex is necessitated by sections 651 and 661 of the Internal Revenue Code ("Code"). Section 651 provides that in the case of any trust the terms of which provide that all of its income is required to be distributed currently, and do not provide that any amounts are to be paid, permanently set aside, or used for the purposes specified in section 642(c), there shall be allowed as a deduction in computing the taxable income of the trust the amount of the income for the taxable year which is required to be distributed currently. Section 661 of the Code, by its title, applies only to estates and trusts accumulating income or distributing corpus. It states that in any taxable year there shall be allowed as a deduction in computing the taxable income of an estate or trust, the sum of any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year) and any other amounts properly paid or credited or required to be distributed for such taxable year, but such deduction shall not exceed the distributable net income of the estate or trust.

Section 1.651(a)-1 of the Income Tax Regulations states that a trust to which section 651 applies is referred to in this part as a "simple" trust. The regulations go on to provide that if the trust is subject to section 661 of the Code, it will be classified as a complex trust. An estate is always classified as a complex trust.

Specifically, section 1.651(a)-1 states that section 651 of the Code is applicable only to a trust whose governing instrument requires both of the enumerated requirements. First, the trust must distribute all of its income currently for the taxable year. Second, the governing instrument of the trust does not provide that any amounts may be paid, permanently set aside, or used in the taxable year for the charitable, etc., purposes specified in section 642(c) of the Code. The third requirement to be classified as a simple trust is one not governed by the trust instrument itself, but rather by action of the trustee. To be a simple trust, the trust may not make a distribution other than that of current income. The regulations make it clear that a trust can still qualify for classification as a simple trust under section 651 for a taxable year in which it is required to distribute all its income currently and makes no other distributions, whether or not a distributions of current income are in fact made. The fiduciary must be under a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed until after the close of the trust's taxable year. See § 1.651(a)-2(a) of the Regulations. Further, the regulations under section 1.651(a)-2(b) make it clear that it is immaterial, for purposes of determining whether all the income is required to be distributed currently, that the amount of income allocated to a particular beneficiary is not specified in the instrument.

Thus, a trust will be considered to be complex for a year in which any of the following occurs: (a) income is required to be accumulated, (b) the trustee has discretion to accumulate or distribute income, even if it does distribute all of its income for the current year, (c) the principal is distributed, or (d) a charitable contribution is made. Finally, a trust cannot be considered to be simple, and thus must be classified as complex, if the trust's definition of "income" fundamentally departs from concepts of local law. See § 1.643(b)-1 of the Income Tax Regulations.

Under the facts as developed by the Field, the Trusts are properly classified as simple trusts for federal tax purposes. No distribution of principal or charitable contribution appears to have occurred in the years in question. Furthermore, the governing documents of the Trusts require that the Trusts' income be distributed currently to the Beneficiaries.

Issue Two

A trust cannot be considered to be simple, and thus must be classified as complex, if the trust's definition of "income" fundamentally departs from concepts of local law. See § 1.643(b)-1 of the Income Tax Regulations. Thus, in accordance with the regulations, state law as to the definitions of "income" and "principal" govern the classification of those terms for federal income tax purposes.

In this case, when the Trusts' governing documents specify that the definitions and state law relating to "income" and "principal" are controlling, it is in accordance with the applicable federal tax regulations.

Issue Three

Form 1041, U.S. Income Tax Return for Estates and Trusts, is the tax return that is used to report any of the following: income deductions gains, losses etc. from the estate or trust; any income that is either accumulated or held for future distribution or is distributed currently to the beneficiaries; income tax liability of the trust or estate; and employment taxes on wages paid to household employees. In addition, Form 1041 requires that the entity to which all of the tax information is applicable be classified. Among the choices provided on Form 1041 for entity classification are both simple trust and complex trust. Using the aforementioned criteria discussed above, the tax return preparer, fiduciary, etc. must determine whether the trust is either simple or complex and check the appropriate box on the return.

Section 1.652(a)-1 of the Regulations provides that a trust may be simple one year and a complex trust for another. This classification is made on an annual basis and is based upon both the governing document of the trust and what distributions the trust has actually made.

For example, a trust can be classified as a simple trust for several years and then, due to the trust's governing document requirement that at the age of majority the trust must distribute the principle to the beneficiary the trust terminates. In the year that the trust is required to distribute the principle of the trust, it would cease to be classified as a simple trust and is classified as a complex trust for that year. The opposite of this can also apply, such as in the case where a trust is complex for several years, being required to accumulate all income of the trust for the benefit of the minor beneficiary. Again, once the beneficiary reached the age of maturity and the trust is required to distribute all of its income, the trust would then be classified as a simple trust.

Thus, it is possible for a trust to have filed a Form 1041 in one year as a simple trust, and file as a complex trust in another year. Furthermore, a trustee who incorrectly files the Form 1041 may file an amended Form 1041 within the allotted time period to correct whatever mistakes have been made on the original Form 1041, including the trust classification. However, based on the facts, as developed by the Field, to appears that these Trusts should always have been classified as simple trusts.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

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By: ______________________________
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